

Age-55 Qualified Retirement Plan Exception

The taxable portion of a pre-age 59 ½ withdrawal taken from a qualified retirement plan or traditional IRA can be hit with a 10% early withdrawal penalty unless one of several exceptions applies. However, the list of exceptions is not identical for qualified plans and IRAs. For example, one exception for qualified plans is available if you are age 55 or older and have separated from service with respect to the sponsoring employer. This age-55 exception is not allowed for early IRA withdrawals.

This age-55 exception is available if both of the following conditions are met:

1. The withdrawal is made after the employee has separated from service with respect to the employer that maintains the qualified plan in question.
2. The separation occurs during or after the calendar year in which the employee attains age 55.

The Seventh Circuit Court recently confirmed that a taxpayer who could have withdrawn funds penalty-free from his former employer's qualified retirement plan under the age-55 exception was hit with the 10% early withdrawal penalty when he rolled over his retirement plan money into an IRA and then took an early withdrawal. The taxpayer argued that the differing lists of penalty exceptions for qualified plans and IRAs were illogical. Not so, said the Court. The tax law says what it says, even though it may not necessarily be logical.

Even worse, the Court also concluded that the taxpayer's failure to pay the early withdrawal penalty triggered the 20% accuracy-related penalty. Taken together, the 10% early withdrawal penalty and the 20% accuracy-related penalty cost the taxpayer over \$24,000. The penalties could have been completely avoided with a little advance planning.

In this specific situation, if a taxpayer separates from service in or after the year he or she turns age 55 and is not yet age 59 ½, he or she should not roll over funds they will soon need into an IRA. Instead, withdraw the needed funds penalty-free from the employer plan and roll over the balance into an IRA. Once funds are in the IRA, the taxable portion of any withdrawals taken from the IRA before age 59 ½ will be hit with the 10% early withdrawal penalty unless one of several exceptions for early IRA withdrawals applies.